Lenders and Loan Dollars Are Plentiful

Borrowers Should Fare Well in Competitive Marketplace

by
Kurt L. Wright, CFA
Equitable Real Estate Investment Mgmt., Inc.

Conditions in the commercial mortgage market remained very positive during the First Quarter of 1996, with problem loans on the decline, market fundamentals still generally attractive and deal parameters in a fairly stable "trading range." There appears to be no shortage of lenders and loan dollars, particularly for high-quality, small- to medium-sized deals, i.e., less than $50 million. In addition, owners of smaller lower-quality properties (e.g., "B" and "C" quality apartments) can choose between a broad range of conduit lenders who have unlimited supplies of capital for high-yield mortgages.

As 1996 unfolds, several key questions currently facing the market should be answered. First, as the pipeline for high-quality deals empties, will lenders relax underwriting standards to win deals? There has been some evidence that this is occurring already. **In pro forma cash flows, there has been a subtle, but discernible, shift in emphasis from current cash flow and current market conditions toward expectations of revenue growth in the 3–5 percent per year range.** Generally, this is warranted. As we move closer to the top of the economic and real estate market cycles, however, objective analysis of individual property characteristics becomes all the more important.

The second major question to be resolved this year is who will step forward and lend on larger properties, particularly the "trophy," CBD, mega-sized office projects? Today, few traditional lenders have appetites for significant exposure to individual assets. Too many lenders were burned by this strategy during the 1980s. Nonetheless, due to the dearth of lenders for deals of $100 million and more, relative value in this sector is strong. This fact, coupled with the tremendous competition that currently exists for smaller deals, will ultimately compel some lenders to step forward.

It's likely that the market will see several large deals done on a syndication basis with two or more lenders — some large state pension funds, life insurance companies and banks — each participating on the order of $50 million or less. Some smaller life insurance companies that previously shunned participation because of the lack of control involved have indicated a newfound willingness to consider syndications. In addition, foreign bank syndicates likely will be chasing these deals as well. For example, the leading contender for the $370 million financing of the AT&T building in Chicago is rumored to be a European bank syndicate. Surprisingly, a Japanese group also is said to be in the fray.

The third question for 1996 concerns the health of the retail property sector, particularly power centers and regional malls. Turmoil amongst retailers continues unabated with no real end in sight. The problem does not seem to be that people are spending less than before on retail products. In fact, the opposite is probably true. The problem lies in the fact that the range of products for which consumers can spend their fixed budgets grows wider and more specialized each day, and products

— *Continued on next page*

Executive Summary

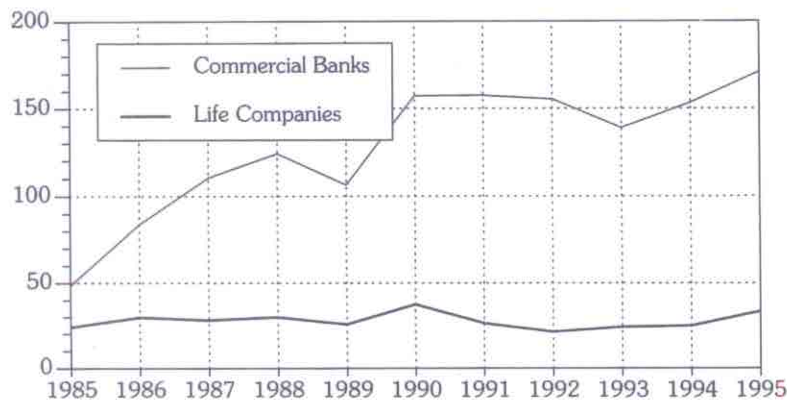
- **There is no shortage of lenders, particularly for high-quality deals less than $50 million**
- **The market will likely see several large deals done on a syndication basis**

Commercial Mortgage Capital Sources

Lender Requirements*	1Q/95	1Q/96
Insurance Companies/Pension Funds ("A" Quality Real Estate)		
Rates	8.45–8.95%	7.65–8.25%
Spreads (UST)	1.25–1.75 bp	1.25–1.75 bp
Max. Loan-to-Value	75%	75%
Min. Debt Service Coverage	1.20x	1.20x
Term	7–10 yrs.	7–10 yrs.
Commercial Banks ("A" Quality Real Estate)		
Rates — Fixed	8.60–9.20%	7.00–8.50%
Rates — Floating	8.25–9.25%	7.15–8.50%
Spreads — Fixed (UST)	1.50–2.00 bp	1.35–2.00 bp
Spreads — Floating (LIBOR)	1.75–2.75 bp	1.25–2.50 bp
Max. Loan-to-Value	75%	75%
Min. Debt Service Coverage	1.15x—1.20x	1.15x–1.20x
Term	1–10 yrs.	1–10 yrs.
Conduits ("B & C" Quality Real Estate)		
Rates	9.30–10.00%	8.30–9.25%
Spreads (UST)	2.10–2.75bp	2.00–2.75 bp
Max. Loan-to-Value	75%	75%
Min. Debt Service Coverage	1.20x	1.20x
Term	5–10 yrs.	5–10 yrs.
* Represents typical transactions, not full range.		

Source: Equitable Real Estate Investment Management, Inc.

Commercial Real Estate Loan Volume
($ billions)



Source: Department of Housing and Urban Development

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Barron's/Levy National Mortgage Survey Spreads

Source: John B. Levy & Company © 1996

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Barron's/John B. Levy & Company National Mortgage Survey

First Quarter 1996		Term of Loan 25-30 year amortization schedule, 0-1 points		
		5 Years	7 Years	10 Years
LOW	JANUARY 8	6.625%	6.750%	6.875%
	FEBRUARY 5	6.625%	6.750%	6.875%
	MARCH 4	7.000%	7.125%	7.375%
PRIME MORTGAGE RANGE	JANUARY 8	6.750-7.000%	6.875-7.125%	7.000-7.250%
	FEBRUARY 5	6.750-7.000%	6.875-7.125%	7.000-7.250%
	MARCH 4	7.250-7.375%	7.375-7.500%	7.500-7.750%
PRIME MORTGAGE RATE	JANUARY 8	6.750%	6.875%	7.000%
	FEBRUARY 5	6.750%	6.875%	7.000%
	MARCH 4	7.250%	7.375%	7.625%

(For loans $5 million and up)
Source: John B. Levy & Company © 1996

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become obsolete more quickly. For example, 10 years ago computer and cellular telephone vendors were dots on the landscape, whereas today they are a staple of power centers and regional malls. As another example, 10 years ago record stores were generally in-line tenants in regional malls. Today the trend is toward giant multi-media stores such as Media Play. As a final example, pay-per-view movies and other direct access movies continue to gain market share. It is merely a matter of time before the prime retail space currently occupied by Blockbuster Video stores is converted to a higher and better use.

Retail tenant viability is on investors' minds. As one lender put it, "It's pretty hard to find a power center deal anymore without some weak link in the key tenant line-up." **This trend toward more specialized products with shorter expected lives extends to the physical real estate itself.** A good location is no longer sufficient to guarantee performance. In addition, the property owner must assemble the most credit-worthy tenants with the most viable product formats. Otherwise, one continually will spend capital to re-create space to meet the next retail specialist's needs.

Despite these concerns, property markets generally are performing very well. Delinquency and foreclosure rates as of year end 1995 were extremely low. As compiled by the American Council of Life Insurance, life insurers' reported delinquencies of 2.37 percent, their lowest level in 10 years. Loans in the process of foreclosure reached a six-year low of 1.41 percent. **The good news on problem loans, coupled with a 60 basis point rise in market interest rates since year end, will be incentives for more lenders to enter the market.**

Spreads on quality properties have been locked in the 125 to 175 basis points range for several quarters. Today, this means that seven- to 10-year mortgages on many "A" quality properties are offered now at rates ranging from 7.75 percent to 8.00 percent based on 75 percent loan-to-value ratio (LTV) and 1.2x minimum debt-service coverage (DSC) ratios. At these levels both borrowers and lenders believe they are getting attractive deals and, therefore, the market will clear very efficiently.

In terms of specific investor appetites, office properties are in the spotlight for many lenders. Both CBD and suburban office projects are potentially attractive, although suburban properties still have the edge. Spreads on quality offices remain rel-

atively high at 140 to 165 basis points. Lenders are still very concerned with the tenant rollover and are requiring escrows for near-term tenant improvements and leasing commissions. Typical terms on most office deals include 10-year maturity, 20- to 25-year amortization, 65 to 75 percent LTV ratios and a minimum of 1.25x DSC. When well-underwritten, office properties offer excellent opportunities today as they still have a long way to go before reaching the top of their cycle.

Hotels are back, although lenders still are underwriting these very conservatively with significant escrows for furniture, fixtures and equipment and plenty of reserves in the cash flow. Since many lenders won't go past 65 to 70 percent LTV ratios, there is considerable opportunity in the market for mezzanine lenders that are willing to fund all or a portion of the 66 to 90 percent portion of the capital structure. Hotel cash flows are so strong today that there is often room to pay the mezzanine investor 15 percent and more on a current basis and still pay the first mortgage lender 150 to 200 basis points over Treasury.

As noted, retail properties require tremendous scrutiny today, and loans on larger properties, especially regional malls, are edging toward contrarian plays. However, quality retail properties are achieving spreads of 130 to 175 basis points for loans with 75 percent LTV and 1.2x DSC ratios. There still is considerable safety and relative value to be found in the smaller size range. For example, anchored neighborhood and community centers in true infill locations often make outstanding debt and equity investments.

Lenders continue to hotly pursue apartment and industrial loans. Apartments are getting more scarce and industrials remain the most difficult property type to source. Financing is widely available today for quality properties with 75 percent LTV ratios and minimum 1.2x DSC at 130 to 150 basis points and a maximum of 30-year amortization. Spreads on certain individual industrial properties have fallen as low as 120 basis points. Both these property types are generally fully valued. Owners of quality apartment and industrial properties are in a great position today to achieve significant positive leverage on maximum loan proceeds.

Loans on larger retail properties, especially regional malls, are edging toward contrarian plays.

__Kurt Wright__ is a senior vice president and portfolio manager of Equitable Real Estate Investment Management, Inc.

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